dispute that resellers should be entitled to compete fairly. However, LA Cellular and GTEM do not believe that stand alone or start-up resellers should be insured profitability through the enforcement of a specific percentage spread between individual elements of a carrier's wholesale and retail tariffs. The need for a spread between wholesale and retail rates affect how resellers should be regulated, therefore, this issue is addressed as a component of the resellers market discussion.

Duopoly Carrier Rate Regulation

Some of the duopoly carriers recommend that their rates should be regulated only to the extent that nondominant interLATA long distance carriers rates are regulated. Other carriers recommend that no rate regulation should be imposed because the duopoly competitive forces are sufficient. However, as discussed in this opinion, competition within the cellular industry needs to be enhanced. Such enhancement cannot take place without some form of rate regulation.

Concerned with the extent of continued rate regulation, parties were requested to comment on the need for general rate case (GRC) proceedings, simplified index methods, rate bands, a historical cost-lower limit, and a statewide rate.

All parties who commented on the historic cost-lower limit, and statewide rates concurred that they are either not necessary or inappropriate for California. Except for Cellular Dynamics, there is agreement that GRC proceedings are not appropriate. Cellular Dynamics recommends the GRC because it does not believe that the duopoly structure has produced a competitive environment.

A rate band procedure is endorsed by Santa Cruz. However, Santa Cruz's approval is conditioned upon a mechanism whereby the individual carriers set the rate bands. Santa Cruz believes that such a mechanism will enable individual carriers to respond to customer demands and to the needs of the marketplace.

U S West concurs with Santa Cruz because it believes that such a mechanism will provide increased competitive incentives, and reduced legal and regulatory costs as benefits to rate bands. No other party recommends the rate band mechanism.

Carriers oppose any simplified index rate mechanism because of the difficulty in determining baseline rates and the impracticability of indexing the myriad pricing packages and options currently available, and expected to increase. Carriers assert that any indexing method will stifle innovation and discourage efficiency.

DRA and CRA propose alternative rate setting mechanisms because they do not believe that the duopoly market structure by itself provides effective pressures to move prices toward competitive levels. DRA recommends a benchmark/sharing approach and CRA recommends a form of cost-based rate regulation.

The benchmark/sharing method requires the setting of rates and setting a return on investment. Initially, the carrier's rates would be set at their current level and a return on investment would be set at a level commensurate with the individual carrier's risk. The carrier's actual return would be reviewed on a yearly basis and compared to a benchmark level. This benchmark level would be set from returns of firms with comparable risks. If the carrier's return exceeds the established benchmark level, the carrier would be required to share the excess between the ratepayers and stockholders.

DRA believes that its proposal is workable because it gives carriers a strong incentive to operate efficiently, and to be responsive to their customers. In addition, it is not a costly time-consuming process because rates start at the carrier's current level.

McCaw does not believe that DRA's rate proposal will work without materially reducing competition and imposing unnecessary costs because DRA's assumptions, methods, and conclusions ignore all of the indirect costs of regulation. Indirect costs components identified by McCaw are the impact of delayed market entry, loss of flexibility, additional cost to the end users due to the lack of alternatives, and lessened service quality. It also disputes whether DRA's proposal can be applied equitably to each carrier because of each carrier's unique operations and cost. For example, terrain and coverage areas require varying system designs. Even within one MSA the two systems have been constructed at different times, with different characteristics.

McCaw believes that DRA's proposal will seriously reduce the continued investment in cellular system improvements and impede technological advancements such as digital conversion.

CRA's method requires each duopoly carrier's operations to be monitored for the first three years of operation. The three-year period is used because initial cellular service in a MSA is less profitable than in a MSA that has established cellular service. Also, the financial performance of each carrier varies.

On every subsequent third year the composite rate of return of the two carriers within the same MSA is compared to a return on equity set at a rate above the minimum required rate for monopoly utilities. The difference between the actual and allowable rate is treated as a rate adjustment. If a carrier disputes the rate adjustment, the carrier is required to show cause why its rates should not be adjusted thereby resulting in a comprehensive review of the carrier's operations.

McCaw disputes the validity of CRA's proposal because the proposal utilizes artificial and hypothetical costs, ratios, capital structures, and capital costs that will not reflect a cellular carrier's operations; rather, it will penalize the higher-cost carrier and encourage a carrier to underinvest in its system in the hope that its capital investment will be less than the composite, thereby increasing its potential earnings and stymie competition.

GTEM also disputes the validity of CRA's proposal and questions whether the carrier's due process is violated by imposing LECs rates-of-return as a basis for a carrier's earnings level.

Although DRA and CRA did not endorse GRC procedures, it is apparent that their alternative proposals will result in such a procedure in order to set a rate of return based on risk. Currently, the energy and major telecommunication utilities have comprehensive cost of capital proceeding to set a rate of return on a yearly basis. D.89-10-031 established an alternative regulatory framework for PacBell which calls for a sharing of profits above a benchmark level and which requires a comprehensive reporting and review process. It is difficult to imagine that if either DRA's or CRA's proposal is adopted, parties will not question the reasonableness of a carrier's cost to operate, resulting in lengthy proceedings.

Both DRA's and CRA's alternative methods are based on a form of cost-based monopoly regulation; i.e., to provide carriers an opportunity to recover their costs and to restrict the carriers' opportunity to earn a profit on their investment. This may be a reasonable procedure to regulate monopoly carriers, however, in the cellular market our regulatory goal is to enhance competition. Neither DRA's or CRA's method will provide the necessary incentive to promote competition, efficiency or encourage new investments.

Further, parties need to be reminded that carrier rates have been set on what the market will bear since 1984. The market rates established in 1984[11] resulted in a projected negative return on equity of 12.17 percent in the preoperative year, a negative 3.31 percent in the first full year of operation, and 18.44 percent and 19.19 percent in the third and fourth year of operation, respectively. The return on equity was a coincidental

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factor to the development of market rates. We recognized that these returns of equity were based on wholesale operations only and that such returns will be enhanced by retail operations.

For the reasons discussed above, regulation of carriers rates based on a rate of return is not appropriate and the proposals of DRA and CRA should not be adopted. Keeping in mind the intent to promote competition for a discretionary service, rates should continue to be based on the market.

Indeed, in D.89-10-031 we cited fundamental concerns regarding the rate of return approach for local exchange utilities, where the dynamics of competition and new technology were substantial reasons for abandoning our traditional regulation in favor of incentive regulation. In the cellular industry, there is no bottleneck monopoly, this is a discretionary service, and technological change and service expansion are key issues. By the same principles we are even less interested in conducting traditional rate cases here.

As discussed earlier, we recognize that profits may be earned by wholesale carriers due to their FCC-granted right to use scarce radio frequencies or spectrum. It is economically efficient and an appropriate spur to system and service expansion for wholesale carriers to keep those profits. However, it is neither efficient nor appropriate for wholesale carriers to earn additional profits due to a failure to compete. As we indicated, such a failure would be demonstrated clearly by the observation that a wholesale carrier's system was operating substantially below the limits of its capacity despite charging prices that more than cover out-of-pocket costs of operation (excluding the amortization of any premium paid to acquire a license). Similarly, the wholesale carriers in a given market could also reap such failure-to-compete profits by failing to expand their system capacity when such expansion was both feasible and economic with respect to current cellular service rates. In that case, the artificial limitation on capacity would keep prices higher than they would be if the systems were properly expanded.

There is also an intuitive reasoning to these scenarios that does not require sophisticated economic analysis. If a cellular carrier is keeping prices high to discourage demand when capacity is clearly available, then the public is losing some of the service it ought to enjoy. If a carrier is refusing to expand capacity because the additional supply would depress prices, then the public is losing the service it ought to enjoy due to the new investment. In either case the cellular wholesaler would be abusing the public trust placed in it by the FCC in its licensing decision and by this Commission in its grant of a CPCN to serve the public.

As we have discussed, it is the proper public policy to forebear from any rate of return or profit-based regulation of cellular wholesalers that are pricing their services competitively. However, we would be disposed quite differently towards a cellular wholesale carrier that violated the public trust by withholding service to make extra profits. If such an instance occurred, we would initiate an investigation of the rates of the carrier in question and impose an appropriate and punitive constraint on its profits.

There is no evidence to convince us that such an investigation should be opened at this time. However, a monitoring program should be devised to keep us apprised of market developments and to give carriers some reasonable expectations of the performance we seek. In essence, we need to be able to answer two questions on an ongoing basis: (1) Is the system reasonably full? (2) Is the system being expanded at a reasonable pace? To answer these questions we will need to understand measures of capacity and utilization, how to evaluate the economics of a decision to expand a system, and how the advent of new and improved technologies matters impact the system, prices, customer complaints, profitability, and the viability of resellers. We will also need to understand "lumpiness" problems in system expansion, where large capacity increases (such as through digitalization) may not be absorbed by the market for some time even with competitive pricing.

Specific methods for performing this monitoring should be an additional subject for the next phase of this investigation through either the workshop or hearing process.

We would emphasize that this monitoring will not be an empty act. The record generally indicates that limits on the spectrum are not a constraint on carriers at the present time. Given the rapid growth in consumer demand for cellular service, that circumstance may change for at least some systems. However, for underutilized systems we will expect rates to fall substantially and quickly following our grant of pricing flexibility in this decision. Further, California's major markets should be converting to digital service as soon as that technology is commercially available. Digital conversion will provide three to four times the present capacity. Carriers will need to cut prices sharply to fill that capacity. If they do not, then we will do it for them based on the results of our monitoring. We will also expect the geographical scope of service availability to continue to expand, with corresponding service quality improvements for the more rural or outlying areas in each service territory.

Duopoly carriers seeking an increase in rates should be required to substantiate their request with market studies specifically based on data within their MSAs. If a carrier wishes to support its request for an increase based on financial hardship, then cost support and income data of a form specified by CACD should be supplied, and carriers should be prepared to respond to other PUC staff requests for supporting financial data. The carrier should also describe the utilization of its system relative to its current engineered capacity. Although a return on investment is not a driving force in setting rates, the carrier should be required to show its actual return on investment and projected return on investment based on proposed rates. Any major increase in return on investment from a three-year recorded average should be supported with specific reasons for the change. Any decrease in rates need not include a market study. Duopoly carriers should file such requests via the advice letter procedure.

LECs Interconnection Arrangements

Facilities-based carriers interconnect subscribers' calls to the LECs network through a Mobile Telephone Switching Office (MTSO). The MTSO originates and terminates calls between the cellular carriers' subscribers and the LECs' conventional wireline customers. As DRA points out, there are three types of interconnection arrangements, Type 1 interface, Type 2A interface, and Type 2B interface. Type 1 interface provides for a trunk level connection between a cellular mobile system (CMS) and a LEC end office. Type 2A interface provides a trunk level connection between a CMS and a LEC tandem switch system. Type 2B interface, similar to a Type 1 interface, provides a trunk level connection between a CMS and a LEC end office. However, the Type 2B interface may be used in conjunction with the Type 2A interface to serve high-volume traffic.

The cost for cellular carriers to interconnect to the conventional wireline service is based on agreements negotiated between the cellular carriers and the LECs. Although some of these agreements are filed with the Commission, none is presently tariffed. Concerned that the negotiated interconnect agreements may place the market power of a LEC monopoly against that of the duopoly purchasers, we requested comments on whether or not a regulatory policy on interconnection arrangements should be imposed.

Need for Uniform Tariffs

All parties concur that similar treatment should be afforded to each cellular carrier. However, as PacTel points out, specific interconnection costs and services vary for each cellular carrier because of the unique network characteristics of each cellular carrier's system and competitive strategy. It is because of the unique network characteristics that the cellular carriers do not recommend a uniform tariff.

The LECs, PacBell, and GTE recommend that the arrangements be tariffed to ensure equitable treatment of all cellular carriers and to establish the proper relationship between interconnection costs and rates. However, they do concede that negotiated agreements will still be necessary for unique interconnection needs.

U S West asserts that current arrangements between LECs and cellular carriers have not been satisfactory because LECs do not provide any cost basis for the rates the LECs charge the cellular carriers and do not offer arrangements within the same time frame that the same arrangements are offered to the LEC's affiliate. McCaw concurs. McCaw and other cellular carriers are also concerned that current arrangements do not compensate cellular carriers for their cost of terminating land-to-mobile calls; i.e., mutual compensation.

Absent mutual compensation, the cellular carriers argue that the arrangements unfairly favor the LECs by containing rates which do not enable the cellular carriers to recover their costs to terminate land-to-mobile calls.

PacBell disagrees with the mutual compensation argument. Contrary to the LECs' franchise requirement to provide basic telephone service, the cellular carriers provide discretionary telephone service. PacBell does not believe that LECs ratepayers should be required to contribute to the existence of a system which provides discretionary services and whose rates are based on what the market will bear.

There are disputes on some aspects of the arrangements. However, parties' comments confirm that there is no need to require LECs to tariff these arrangements. To do so will only result in burdensome tariff filings and modification of the tariffs to provide for unique arrangements, which may turn out to be the norm because of distinct network arrangements. Rather, minimum regulatory oversight on these arrangements can continue to exist by implementing controls to assist the LECs and cellular carriers in good faith negotiations.

The dispute on whether the LECs actually incur the cost to provide an arrangement to a cellular carrier should be resolved between the LECs and cellular carrier in the good faith negotiation process. The LECs should be required to support their costs to provide such service to the cellular carrier. The LECs' cost should consist of the LEC's actual cost to provide an arrangement and provide the LECs a marginal contribution based on the LECs' opportunity cost. Opportunity cost represents that return on investment that the LEC could earn if its funds were invested in its other regulated operations.

We are mindful of the concerns expressed by McCaw when one of the wholesale carriers is also an affiliate of the LEC. Although the LEC charges the same interconnection prices to both wholesale carriers, revenue from the LEC affiliate may flow from one arm of a holding company to another. In that case the fact the LEC charges the same price to its affiliate as to the unaffiliated carrier may not serve as an effective protection against overpicing of interconnection. This is a further reason for us to state that cellular interconnection should be cost based.

As discussed in this opinion, LECs' customers have no advanced knowledge that they are calling a cellular number, a discretionary service. Absent a means of identifying cellular numbers and educating the basic telephone customers about high-cost cellular service, any mutual compensation will increase the cost of basic telephone service. Also, should such compensation be authorized, equal treatment should be afforded to other types of entities that terminate a basic telephone call such as telephone answering services, PBX (Private Branch Exchange) owners, shared tenant service providers, and IECs with direct connections to their customers.

To require LECs ratepayers to compensate cellular carriers for call termination will unnecessarily increase the cost of basic telephone service for the provision of discretionary cellular service. Mutual compensation should not be incorporated into arrangements at this time.

To alleviate the anticompetitive discrimination concern against cellular carriers that are not affiliated with a LEC, we will adopt DRA's proposal requiring all future interconnection agreements to include a mandatory nondiscriminatory clause. The clause shall state that the terms and conditions of the agreement shall be nonexclusive and shall be offered on a nondiscriminatory basis to other cellular carriers.

The controls discussed above are intended to provide the LECs and cellular carriers sufficient incentive to negotiate arrangements in good faith and to reach a reasonable settlement. Absent such a result, as Santa Cruz discusses in its comments, Public Utilities (PU) Code § 762 provides us the necessary authority to intervene in interconnection negotiations as needed.

Comments on whether the cellular carriers are building their own access and toll networks to avoid LECs rates and on the offering of toll free rates to cellular subscribers calling across LATAs, substantiate that neither situation is occurring. These concerns are therefore moot unless evidence emerges to the contrary.

However, CRA's comments contain a proposal whereby cellular wholesale utilities should be required to offer unbundled access to resellers so that the resellers could perform call-switching functions. By a December 11, 1989 ruling, the assigned Commissioner ruled that hearings would be set after this interim opinion so that resellers may present a detailed proposal for consideration.

Access Charges

An access charge is a tariff charge imposed on either an end user or an IEC to compensate a LEC for the origination and termination of a call; i.e., the connections between end users and the non-LEC carriers via LECs provided facilities. Access charges were established to compensate LECs for costs incurred for originating and terminating interexchange traffic. (D.83-12-024, p. 6, et seq. and citations therein.) Access charges for switched access are comprised of several rate elements. (See, for example, PacBell's Schedule Cal. P.U.C. 175-T, Sec. 6.1.3; 6.8.) One of these elements, the carrier common line charge or "CCLC", is based on an assignment of nontraffic sensitive ("NTS") cost recovery. NTS costs include costs of providing and maintaining the local loop. (D.83-12-024, D.85-06-115, D.87-08-048.)

Some of the Type 2A interconnection agreements between PacBell and the cellular carriers contain a single mobile-to-land minute of use (MOU) rate element which was developed, in part, from cost studies for the switched access rates PacBell charges to IECs. This MOU rate does not reflect any assigned recovery of NTS costs or the CCLC access charge rate element. PacBell does not include in contracted interconnection rates for cellular interconnection any discrete assigned recovery of NTS costs.

PacBell and GTE charge cellular carriers and IECs an access charge for Type 2 connections based on MOU. MOU cost elements consists of a local/switch transport component, an end office switching component, a line-termination component, and an intercept component. An additional component, common line MOU, is charged only to the IECs for the use of the LECs network between the LECs end office and customer premise.

Both the cellular carrier and the LECs provide telephone service in a specific geographical area. The cellular carriers provide discretionary cellular radio service and the LECs provides basic telephone service. Cellular carriers provide discretionary local service, and are capable of providing end-to-end service to their subscribers and interchange traffic with each other, similar to the LECs. Therefore, cellular carriers should be classified as a LEC co-carrier, as proposed by DRA and other cellular carriers.

Cellular carriers argue that as a LEC co-carrier, they should not be required to subsidize the LECs' landline network nontraffic costs via access charges.

On the other side, PacBell asserts that although cellular carriers are not IECs, they do access and benefit from the LECs' local loop. Since interconnected companies, including cellular carriers, obtain the benefits of local loop access, PacBell asserted that the cellular carriers should contribute towards the recovery of the NTS loop costs.

While the co-carrier argument is not strong enough to argue for reciprocal access charges at this time, it does persuade us not to levy a contribution requirement on cellular access charges. Unlike IECs, cellular carriers do supply an end user infrastructure that completes calls. LEC customers can complete calls to end users on cellular networks just as cellular customers can complete calls to end users on LEC networks. Thus, we will not require that cellular carriers pay a NTS contribution, but only the actual interconnection costs.

These determinations regarding interconnection and access charges may be revisited in the future if in fact cellular carriers and landline LECs become much more equal in terms of the co-carrier status suggested by McCaw. We would look to statistics such as relative numbers of customers served and the relative origination and termination of calls to make such a judgment.

Resellers Market

The retail market was created in 1984 by the same decision which granted Los Angeles Statistical Metropolitan Service Area Limited Partnership, California's first cellular wholesale certificate. D.84-04-014 authorized a resale plan to provide a viable business opportunity for the resellers and to mitigate any adverse effects of the early entry of the wireline carrier into the cellular market. The decision also required each entity desiring to enter the retail market to obtain a CPC&N. However, the decision emphasized the ease of entering the reseller market by stating that reseller CPC&Ns should be authorized on an ex parte basis to the maximum extent possible. Retail rates were based on market determined prices.

Today the reseller market is comprised of duopoly carriers, affiliates of duopoly carriers, and independent resellers. A DRA survey shows that 14 facilities-based carriers, 3 duopoly carrier affiliates, and 44 independent entities had CPC&Ns to provide retail services in 1988. It also shows that the independent resellers' market share[12] was 16 percent in 1988, an increase of 6 percent from 10 percent in 1985. For the comparable time period, the duopoly carriers market share diminished to 70 percent from 76 percent while the duopoly carrier affiliates maintained a 14 percent market share.

A major concern of this investigation is to determine whether the current retail price regulation is appropriate. Therefore, parties were requested to comment on the current retail

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12 DRA utilized cellular service revenues to derive its market share ratios.

market conditions, the need for a wholesale/retail rate spread, and on subsidization between the wholesale/retail market.

Current Market Conditions

Parties were requested to comment on how the current retail market is working. CRA believes that the retail market is not working "as well as it should" because of the lack of competitive pricing. Absent an increase in the duopoly carriers' rate spread between wholesale and retail rates, CRA asserts that resellers will be a short-lived phenomenon lacking significant opportunity to compete.

Although CRA offers a bleak picture for the retail market, Cellular Dynamics concurs with carriers that the wholesale and retail margins are adequate. However, Cellular Dynamics restricts its concurrence to the markets where the duopoly carriers support adequate margins, such as in the Los Angeles market where Cellular Dynamics obtains approximately one out of every five new subscribers.

Cellular Dynamics contends that a healthy retail market reduces the ability of the duopoly carriers to coordinate wholesale pricing and therefore to exercise market power. It concludes that a healthy retail market will produce lower and creative pricing for the end users.

The duopoly carriers represent that the retail market is functioning well. McCaw substantiates this conclusion by emphasizing that the resellers' revenue share has increased from nothing in 1983 to over $86 million in 1988 and its recognition that several resellers report substantial net incomes without being required to provide the substantial amount of investments that the duopoly carriers are required to provide.

PacTel concurs with McCaw. The results of a PacTel survey show that of the approximately 30 retail carriers entering the market since 1986, 40 percent entered the market in 1988 and a additional 40 percent in 1989, or 10 new retail carriers in 1988 and 14 in 1989. PacTel attributes this rapid entry to the relatively low regulatory barriers to entry and the minimal capital requirements that retail carriers need to obtain an efficient and profitable business.

PacTel also represents that 5 of the 7 certificated resellers who recently left the market sold their customer list to other resellers, four of which sold their business for more than $600 per subscriber. More recently, by A.90-03-010, Cellular Dynamics proposes to acquire a portion of California Cellular Communication Corporation's (another reseller) customer accounts. The terms of the agreement includes a provision that Cellular Dynamics will assume a $30 monthly payment per customer account for a 13-month period, or $390 per customer account.

DRA also conducted a study. Its study, based on data requests to resellers, shows that resellers function adequately during their initial start-up period as well as during subsequent periods of time. Although resellers complained about duopoly carriers' high commission rates causing excessive churn rates, the resellers believe that their own expectations for customer growth are reasonable. Thus, DRA believes that, in terms of customer growth, the market is functioning reasonably well. However, DRA does believe that rates to end users should be lower.

DRA is concerned that a substantial increase in the number of independent resellers through regulatory action will merely redistribute wholesale profits to the additional resellers. As long as entry into the reseller market is relatively easy, DRA sees no need for a great number of active resellers for competition to function at the retail level.

Carriers', CRA's, and Cellular Dynamics' comments on the possibility of retail rates being high, parallel their comments on high wholesale rates. Therefore, such comments will not be repeated. Those parties who represent that retail rates are high, such as CRA, argue that the cause of such high rates is ineffective competition between the duopoly carriers.

GTEM acknowledges that retail rates are a function of wholesale rates. However, it argues that comparisons of prices charged in various markets throughout the state are limited because consideration must be given to the relevant cost of providing service in each market and to the risks associated with such capital investment.

To the extent that retail rates in some California markets are higher than retail rates in other markets throughout the country, GTEM reminds parties that there are valid reasons for such differences. Some of the reasons offered by GTEM are the cost of land and switching facilities, unique and varied topography, CEQA requirements, and the extent of state regulation.

Similar to the wholesale market concerns previously discussed, parties are at odds about whether or not there is sufficient price competition within the (resellers) market. To address this concern, parties commented on the spread between the duopoly carriers wholesale and retail rates alluded to by GTEM's comment that retail rates are a function of wholesale rates.

Wholesale and Retail Rate Spread

The current regulation of retail rates and the margin between retail and wholesale rates has not enhanced price competition. McCaw demonstrates in its comments that a margin between the wholesale and retail rate only encourages resellers to price their services at the same level as the facilities-based carriers. For example, in the Los Angeles market, both facilities-based carriers charge a $50 customer activation fee, a $45 monthly access fee, and a $0.35/$0.27 peak/off-peak rate for basic service. In addition, the 35 resellers in the same market area identified by McCaw charge the same rates for basic service as the facilities-based carriers. Although the rates are different in other MSAs, the results are similar to that of the Los Angeles market.

CRA recommends a larger spread between the wholesale and retail rates so that the resellers may compete profitably within the retail market. This is because 74 to 79 percent of the retailers' cost to furnish retail services represents the cost a retailer must pay to the facilities-based carrier. However, DRA believes that any increase in the retail margin from the facilities-based carriers will only increase resellers' profitability in the short run.

In the long run, DRA believes that any increase in the margin will only encourage more firms to enter the retail business because of the resellers' increased profitability. Therefore, it recommends that a volume discounting procedure be adopted that does not guarantee resellers financial viability in place of the current wholesale/retail margin.

McCaw's data substantiates that the margin method has not enhanced price competition in the retail market. Therefore, should such a procedure continue, there is no reasonable basis to assume that retail price competition will occur if the margin is required to be increased. Absent such assurance there should be no mandatory margin, let alone an increased margin between the wholesale and retail rates. The facilities-based carriers should be responsible for innovative pricing schemes if true competition is to exist. Although DRA's volume discounting proposal is not specifically being adopted, facilities-based carriers are encouraged to consider DRA's proposal in developing innovative tariffs for retail services. The only restriction to such innovative tariffs should be to preclude the facilities-based carriers from setting wholesale rates that discriminate in favor of their own retailers.

Consistent with DRA's logic, we do not see the need to maintain a particular margin between volume discounts and individual customer rates. The wholesale carriers have the incentive to offer bulk discounts to the extent that such arrangements reduce the costs of functions such as advertising and the servicing of customer accounts. Resellers that can perform these functions more cheaply or better will have a continuing place in the market.

The argument concerning the retail margin parallels that concerning the reasonableness of commissions paid to agents, which is the next section of this decision. Resellers are arguing that they cannot be profitable given both the current margins and the competitive business practices that have become commonplace among both carrier retail operations and resellers. Resellers ask either that the competitive activities of carriers be limited or that the retail margins be increased.

As DRA points out, increased margins or earnings for resellers do not necessarily benefit consumers, and could cause the public to pay higher prices. On the other hand, the resellers claim that the carriers are unfairly subsidizing their retail operations and that a resulting loss of competitive resellers would harm consumers by limiting choice. The resellers characterize the situation as anticompetitive behavior that the Commission should control.

We will move to control any potential cross-subsidy problem directly. Rather than imposing specific margins or price limits on carrier retail operations, we will require that they at least break-even on a rational business basis. If a carrier's retail operations are covering all of the costs directly associated with that business, then the carrier is not cross-subsidizing retail out of wholesale revenues or earnings. In that case, the carrier is not pricing predatorily towards the resellers, and the cellular retail market can function like any competitive market with the customer base and earnings going to the firms that offer the best service at the lowest cost. Given these circumstances, we are indifferent as to whether resellers serve any or all of the market, or whether the carriers continue to provide retail service or even seek to leave that end of the business.

We will therefore provide that the cellular USOA be revised to incorporate cost-allocation methods for the carriers' wholesale and retail operations in the next phase of this proceeding. We can draw on the record before us to identify some of the issues that will occur in that process and to offer guidance to the parties. First, the purpose of this USOA will be to police predatory pricing. From the rational business perspective, costs that the carrier must incur due to offering wholesale service are properly allocated or assigned in their entirety to the wholesale side if those costs could not be avoided if the carrier discontinued retail service. Second, commissions to agents should be included on the retail side unless the carrier pays them to all who deliver new customers (including resellers). In the next section we say more about the proper accounting treatment of commissions. Finally, retail costs should include a rate of return on investment dedicated to retail service that would not be needed for wholesale-only operations.

Retail profitability will be monitored on a service-area wide basis. We recognize that start-up costs to serve new areas or markets may be offset for some period by profits from more established parts of the business. As long as the overall carrier retail operation is not subsidized, carriers will be in compliance with this requirement.

Until this revised USOA is put in place by further Commission decision, carriers shall not use temporary tariffs to make rate changes that reduce the current margins between wholesale and retail rates. Instead, rate changes that would reduce margins shall be filed as rate changes have been up to now, that is as advice letters for approval by Commission resolution. Resellers or other interested parties may protest these filings; to gain our approval, the carrier must make a showing that the reduction in retail margin will still be profitable.

Once we approve the new USOA, we will begin monitoring carriers' retail profitability and carriers may use temporary tariffs to make rate changes that reduce retail margins.

We will require carriers to report on their retail revenues and expenses each six months. If retail revenues do not equal or exceed retail expenses, then the carrier will lose its ability to reduce the retail margin through temporary tariff filings. If a carrier's retail expenses exceed its retail revenues for two consecutive six month periods, then we will open an OII in which the carrier will have the burden of explaining why its retail operations have not been compensatory. If we find that the carrier has in fact cross-subsidized its retail operations during that period, we will impose sanctions that will potentially include but not be limited to a partial refund to resellers of wholesale rates they paid to the carrier. A reseller would be refunded a part of the wholesale rates it had paid, calculated in proportion to the amount of money the carrier's retail operation lost divided by the total dollars paid by the carrier's retail operation for wholesale service.

In other words, we would calculate what the wholesale tariff price would have to have been for the carrier's retail side to have broken even. It would be as if the carrier's wholesale tariff had been at a price at which the carrier's retail operations would not have been subsidized, and as if the resellers had been paying that lower wholesale price during the period in question. This would assure that both resellers and carrier retail operations are in effect buying out of the same tariff. To the extent that carrier retail operations can sustain continuous losses, the retail operations must be receiving an effective cross-subsidy from other carrier revenues.

A carrier whose retail operation loses money during one six-month period but makes money during the subsequent period would regain its pricing flexibility if the losses in the prior period (on a per-customer basis over the average number of customers in each period) were equalled or exceeded by the profits in the subsequent period. Otherwise, a carrier would need two consecutive break-even or better periods to regain its pricing flexibility.

Procedurally, we will enforce this monitoring requirement through periodic filings to be provided to CACD. We will delegate to the Director of CACD the ministerial duty of verifying the carriers' calculations and certifying, by letter, their current status of either unrestricted temporary tariff authority or restricted temporary tariff authority. The Director of CACD will also recommend the issuance of OIIs should they be necessary. Carriers should have their compliance with their allocation methods verified annually by external auditors. A precise schedule for this monitoring will be included in our decision adopting the new retail cellular USOA.

By this opinion, other steps are being implemented to enhance competitive pricing between the facilities-based carriers and to encourage retail price flexibility. The most common concern among facilities-based carriers is the time period before a tariff can be implemented. With the new tariff guidelines adopted in this opinion, carriers will be able to implement innovative tariffs without providing advance notice to their competitors. Similar types of regulatory incentives are being afforded to the retailers with the intent of enhancing retail price competition.

Although some tariff changes have already been addressed, it is important to note that resellers have, on a case-by-case basis, been determined to be a nondominant telecommunications carrier. An example of such determination can be found in D.85-06-015, Advanced Cellular Phone Co. U-4030-C. To date there is no generic proceeding in which this nondominant status has been determined.

Comments filed in this investigation confirm that the reseller market is a competitive service with minimal market power and has limited ability to influence cellular prices. Rather than continuing to review reseller applications on a case-by-case basis, we conclude, based on the comments filed in this investigation, that retail cellular carriers not associated with facilities-based carriers should be classified as nondominant telecommunications carriers. This nondominant status should not be applicable to entities which either have or are applying for a FCC facilities-based license. As nondominant telecommunications carriers, the resellers should be exempt from PU Code §§ 816-830 and exempt from Section 851 with respect to transfers or encumbrances made for the purpose of securing debt or customers.

Similar to other nondominant carriers, nonfacilities-based retail cellular carriers should be authorized to file tariffs applicable to cellular services, including rates, rules, regulations, and other provisions necessary to offer service to their end users. Such filings should be made in accordance with GO 96-A, excluding Sections IV, V, and VI, and should be effective upon filing if rates will not decrease a carrier's customers average bill by more than ten percent. With respect to rate increases, or decreases in excess of ten percent, nondominant carriers will be subject to the advice letter process applicable to similar rate increases sought by facilities-based carriers.

We are aware that the tariff rules for nondominant carriers are under review and may be made less flexible. With respect to all tariff matters except rates, we will provide that cellular resellers may use the more flexible of the procedures provided to cellular carriers in this decision or those we ultimately require for other nondominant carriers.

<u>Wholesale/Retail Market Subsidization</u>

Since the inception of the wholesale/retail market in 1984, resellers have filed numerous complaints against carriers subsidizing their operations with commission schemes. C.86-12-023, consolidated with this investigation so that such subsidy issues could be addressed on a generic basis is only one of the complaints.

CRA asserts that exorbitant commission payments permit agents to sell customer terminal equipment below cost, a perverse anticompetitive market incentive to the end user so that the end user will subscribe to a particular carrier's cellular service.

With the artificially low price of equipment, CRA believes that the agents are able to obtain sizeable commission payments for certain carriers while requiring an end user to subscribe to a specific carrier's service, without the benefit of making an independent selection of a carrier for service quality or rates for the end user's service needs.

In an attempt to resolve the issue of artificially low price of equipment, parties to C.86-12-023 agreed to the following guidelines.

a. No provider of cellular telephone service may provide, cause to be provided, or permit any agent or dealer or other person or entity subject to its control to provide cellular telephone service at any rate other than such provider's tariffed rate. No such provider may permit any agent or dealer or other person or entity subject to its control to pay for all or any portion of the cellular service which it provides to any customer.

b. No provider of cellular telephone service may provide, either directly or indirectly, any gift of any article or service of more than nominal value (e.g., permitted gifts would be pens, key chains, maps, calendars) to any customer or potential customer in connection with the provision of cellular telephone service.

c. No provider of cellular telephone service may provide, cause to be provided, or permit any agent or dealer or other person or entity subject to its control to provide to any customer or potential customer any equipment price concession or any article or service of other than nominal value which is paid for or financed in whole or in part by the service provider and which is offered on the condition that such customer or potential customer subscribes to the provider's cellular telephone service.

D.89-07-019 pertaining to an agent's practice of selling discounted cellular equipment so that end users would agree to purchase cellular service from a specific carrier, concluded that cellular equipment discounts, contingent upon the purchase of tariffed cellular services, violate PU Code §§ 532 and 702 if those discounts are offered by utilities or their agents. Similarly, conditions on cellular services that differ from those in effective tariffs are unlawful if they are imposed by carriers on their agents.

We will adopt the above guidelines and reemphasize our intent to enforce the provisions of D.89-07-019.

The second cross subsidization issue is whether the payment of commissions to carriers' agents prevent resellers from entering the cellular market and maintaining a viable cellular resale business. A related issue in C.86-12-023, consolidated with this investigation, is whether commission payments to agents should be restricted to no more than $50 per cellular telephone number activation.

PacTel and other carriers acknowledge that commission payments of up to $350 per activation are made to agents. However, the carriers represent that they do not cross subsidize their own